

LEGISLATIVE AUDIT DIVISION

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MEMORANDUM

TO: Legislative Audit Committee Members

FROM: Jim Pellegrini, Legislative Auditor, Performance Audits

Date: December 3, 2003

RE: Follow-up to Performance Audit:
Microbusiness Finance Program (00P-08)

A handwritten signature, likely of Jim Pellegrini, in black ink.

INTRODUCTION

In November 2000, we presented our performance audit of the Microbusiness Finance Program to the Legislative Audit Division. The audit objectives were to evaluate the status of the program's loan portfolio, determine if the program is operating efficiently and meets legislative intent, and assess program outcomes. Our audit identified a number of concerns with the quality of the program's loan portfolio. We also found the Microbusiness Development Corporations (MBDCs) were not financially self-sustaining as required by the legislature. We made several recommendations to improve program operations. This included a recommendation to the legislature to determine the future of the Microbusiness Finance Program.

Our follow-up work found the Department of Commerce has done a good job of implementing the audit recommendations. However, we also noted the program continues to have a significant number of late and delinquent loans and most Microbusiness Development Corporations (MBDC) are still not financially self-sustaining as intended by the legislature. The legislature may once again need to evaluate the future of the Microbusiness Finance Program and could consider three options for the program:

- The program could continue to operate and be given more time to see if the department's changes eventually improve how efficiently and effectively the program operates.
- The program could be eliminated and all MBDCs and/or their umbrella agencies be required to pay back all development loans and continue to collect outstanding microloans until fully collected.

- The Microbusiness Development Act could be amended eliminating the need to use local MBDCs to make microloans. Instead, the program could make funding available to local banks to make microloans to borrowers. This could potentially improve the quality of loans that are made.

BACKGROUND: MICROBUSINESS FINANCE PROGRAM

The Montana Legislature created the Microbusiness Finance Program in 1991 through passage of the Microbusiness Development Act (Title 17, chapter 6, MCA). The legislature approved an initial appropriation of \$3.25 million from the state's Coal Tax Trust Fund and an additional \$3.25 million from the trust fund in 1995 to make loans to microbusinesses. Microbusinesses are defined as those having fewer than 10 employees and less than \$500,000 in annual gross revenues.

Three types of entities administer the Microbusiness Finance Program. The Department of Commerce is responsible for statewide program oversight. Its main duties are to fund local Microbusiness Development Corporations (MBDC) through development loans (i.e. coal tax funds) so MBDCs can make loans to businesses. The department is also responsible for ensuring the MBDCs use these funds appropriately. MBDCs are local non-profit entities that provide training, technical assistance, and loans to microbusinesses. MBDCs are part of larger "umbrella entities," such as Human Resource Development Councils or local economic development agencies. At the time of the audit, the Microbusiness Advisory Council (as required by state law) advised the department regarding the operation, maintenance, and policies of the Microbusiness Finance Program. The 2003 Legislature passed House Bill 76, which eliminated the Microbusiness Advisory Council and created the Economic Development Advisory Council. The duties of the Microbusiness Advisory Council were rolled into the responsibilities of the Economic Development Council.

MBDCs can make loans of up to \$35,000 to qualified businesses for working capital, equipment, and other fixed assets. Applicants are generally required to prepare a business plan to demonstrate the feasibility of the business idea, the ability of the business to generate sufficient cash flow to repay the loan, and provide income for the owner. Applicants are required to provide information to the MBDC loan officer for review including personal and business financial statements, tax returns, and loan applications. Terms and conditions of each loan vary according to the needs of the business and the useful life of the equipment or assets being required. Since the intent of the program is to finance projects that are not able to obtain financing from other sources, such as a bank, interest rates charged by MBDCs are generally higher than bank rates.

MBDCs are funded mainly by interest collected on microloans they make. They also receive revenue from other sources such as loan fees. The original intent of the Microbusiness Finance Program was for MBDCs to become self-sustaining.

Audit Conclusions

Our audit identified several concerns related to the sustainability of the MBDCs and the overall condition of the microloan portfolio. The following section outlines the major

conclusions made during the audit (shown in *italics*) along with a brief update on their current status.

- ▶ *The overall microloan portfolio has a high delinquency rate and potential for significant loan losses.* Follow-up work found several MBDCs still have microloan portfolios that have high delinquency rates and potential for significant loan losses. For example, 53 percent of the loan portfolio in Wolf Point has payments 30 days or more past due.
- ▶ *The department reports that cumulative microloan write-offs are just under 8 percent. However, the amount written off is generally understated compared to what actually exists because doubtful loans are often kept on the books.* Based on the level of loan delinquencies, it appears MBDCs are continuing to leave doubtful loans on the books.
- ▶ *Variances exist between MBDCs in the number of loans made, and the number of loans has dropped in some areas during the last two years.* We did not compare the number of MBDC loans made since the completion of the audit. However, we did compare the size of MBDC outstanding loan balances and there is a smaller difference between them since the completion of the audit.
- ▶ *Most MBDCs are not financially self-sustaining, and it is unlikely they will be as intended by the legislature.* Our review found there is still a statewide net loss for the MBDCs and most MBDCs are still not self-sufficient.
- ▶ *There are weaknesses with lending procedures followed by some local MBDC lending staff.* The department improved this area by creating more standardized policies and procedures to make lending practices more consistent among MBDCs. In addition, several different types of lending-related training is also being provided to MBDC staff.

SUMMARY OF FOLLOW-UP RESULTS

Our audit report made five recommendations with nine suggested changes to improve program operations. The table below shows the status of the recommended changes made in the audit.

<u>Recommendation Status</u>	
Implemented	7
Being Implemented	2
Not Implemented	0

As the table shows, the department has implemented (or is implementing) all the recommendations. The following sections discuss each recommendation and the steps taken to implement each one.

Recommendation #1

We recommend the Legislature determine the future of the Microbusiness Finance Program.

Status

Implemented. Legislation was introduced during the 2001 and 2003 legislative sessions related to the Microbusiness Finance Program. House Bill (HB) 49 was introduced during the 2001 session requesting additional funds be appropriated to the program from the Coal Severance Tax Permanent Fund. HB 49 was not adopted by the legislature so no additional funding was provided to the program. During the 2003 Legislative Session, HB 76 was passed with the intent to develop greater capacity for economic development on a regional basis. This was accomplished by creating 12 regional development organizations (called Certified Regional Development Corporations) that will provide technical and financial assistance on economic and community development efforts. This bill also eliminated the Microbusiness Advisory Council and created the Economic Development Council. The Economic Development Council will advise the Department of Commerce regarding the operation of the certified regional development corporations and the Microbusiness Finance Program. We noted most MBDCs are still not self-sustaining and the program continues to have high delinquency rates in its loan portfolio. Consequently, there may be a need for the legislature to once again evaluate the future of the program.

Recommendation #2

We recommend the Department of Commerce:

- A. Make additional resources available to MBDCs to provide training to staff.**
- B. As part of contract renewal, require lending staff to complete specific loan-related training.**

Status

A and B are implemented. The department budgets approximately \$10,000 annually to provide training to MBDC lending staff. These funds are used for expenses such as training facilities and training registration costs. MBDCs are responsible for paying per diem for staff they send to training. The department establishes an annual training plan offering a wide variety of lending related training courses to MBDC loan staff. Examples of training that has been provided include collecting bad loans, evaluating cash flow analysis, proper loan documentation, and understanding and using tax returns. The Department of Commerce also purchased loan documentation software for the MBDCs.

Recommendation #3

We recommend the Department of Commerce:

- A. Establish minimum qualifications for MBDC lending staff.**
- B. Evaluate whether MBDCs are hiring staff that meet the minimum qualifications.**

Status

A and B are implemented. The department has established minimum qualifications MBDC lending staff must meet and this language has been included in development loan agreements between the MBDC and the department. MBDC loan officers must meet minimum education and experience qualifications including a Bachelor's Degree in accounting, finance, marketing or business administration and have one year of experience working directly with small business in an advisory or lending capacity. Each time an MBDC hires a new loan officer, a copy of their resume must be submitted to the Department of Commerce.

Recommendation #4

We recommend the Department of Commerce:

- A. Provide sample policies and procedures to MBDCs describing the proper lending process.**
- B. Review and approve MBDC lending policies and procedures.**

Status

A and B are implemented. In 2000 and 2001, the department provided sample policies and procedures to all MBDCs asking them to adopt them as their lending manual. All actively lending MBDCs adopted the procedures and made changes where needed to better fit their local operations. Once adopted, the MBDCs provided copies to the department. In November and December 2002, department staff visited the MBDCs to review compliance with the newly adopted procedures.

Recommendation #5

We recommend the Department of Commerce:

- A. Develop outcome measurements for the Microbusiness Finance Program.**
- B. Establish a system to collect information and measure program outcomes.**

Status

A and B are being implemented. The department continues to compile information regarding program operations on a quarterly basis. Examples of information collected include the number and dollar amount of loans, the number of loans paid in full, average loan size, and the number of jobs created or retained as a result of a loan. Department officials said the MBDCs try to update information related to the number of jobs created during annual visits with the borrower. The department and MBDCs have conducted borrower surveys in an attempt to obtain information related to whether businesses are still owned and operated by the borrower, the current number of employees for the business, gross annual business revenues, and whether the business was able graduate to bank financing. Department staff said they are still trying to determine what kinds of data would provide the most useful outcome measurements and also develop a reliable system to collect this information. Department staff said one of their main challenges in obtaining outcome measurements is obtaining information from borrowers. This is because businesses often believe information the department is trying to collect is

confidential. The department is in the process of developing a “Microbusiness Finance Program Borrower Questionnaire” to help them collect outcome data from businesses. They said they want to develop a questionnaire that obtains useful data but still protects the privacy of the businesses. Information currently included in the questionnaire includes reasons borrowers no longer operate the business, the number of employees currently working at the business and before the microloan was obtained, the range of salaries paid for hourly workers, and the types of benefits employees receive.

MICROBUSINESS PROGRAM FINANCIAL CONDITION IS STILL QUESTIONABLE

As shown in the previous sections, the Department of Commerce has done a good job implementing the audit recommendations. In addition, they have implemented other procedures in an attempt to improve Microbusiness Finance Program operations. For example, the department has implemented an on-site review process of MBDC loan files to determine if proper lending procedures are followed. Two MBDCs that had weak loan portfolios have also ended their participation in the program and are in the process of paying back their development loans to the department. These MBDCs are also continuing to collect their outstanding microloans from borrowers. Despite the positive changes the department has made and two MBDCs leaving the program, the financial condition of the Microbusiness Finance Program is still questionable. The following sections provide information related to the program’s loan portfolio and the financial condition of the MBDCs.

Program Continues To Have High Loan Delinquency Rates

The number of late payments and delinquency rates are one way to measure the quality of a loan portfolio. Late payments are those that have not been paid 1 to 30 days after their due date. A payment is considered late when it is up to 30 days past due. Delinquent payments are those that are 30 or more days past due. Table 1 illustrates late and delinquent payments for each MBDC loan portfolio.

Table 1
Microloan Late and Delinquent Payments by MBDC
(Quarter Ending 6/30/03)

<u>MBDC</u>	<u>Outstanding Loan Balance</u>	<u>1-30 Days</u>	<u>Percentage of Loan Balance</u>	<u>Over 30 Days (Delinquent)</u>	<u>Percentage of Loan Balance</u>
Billings	\$ 182,624	\$ 1,450	1%	\$ 44,140	24%
Butte	167,545	31,543	19%	10,727	6%
Colstrip (1)	51,888	7,543	15%	3,155	6%
Great Falls (1), (3)	146,527	0	0%	0	0%
Havre	468,033	38,443	8%	103,744	22%
Helena	316,632	3,808	1%	0	0%
Kalispell	362,541	5,367	1%	140,373	39%
Missoula	222,044	53,602	24%	0	0%
Wolf Point	373,453	34,624	9%	196,746	53%
Total	\$ 2,291,287	\$ 176,380	8%	\$ 498,885	22%

- (1) MBDCs are no longer participating in program. They continue to collect outstanding loans and are repaying its development loan to Department of Commerce.
- (2) MBDC was no longer participating in program during our audit and was in process of paying back its development loan. The loan has been paid in full.
- (3) Since completion of audit in November 2000, Great Falls has written off \$90,991 in microloans. Only \$6,465 has been recovered to date.

Source: Compiled by the Legislative Audit Division from program records.

As the table shows, the statewide average for late payments is eight percent which is the same percentage identified during the audit. The average statewide percentage for delinquent payments is 22 percent. This is two percent higher than identified during our audit. Our follow-up work found the late and delinquent payments had improved for some MBDCs while increasing for others. The largest increases in delinquent payments were noted in Kalispell and Wolf Point. Kalispell's delinquent payments increased from 26 percent to 39 percent of its loan portfolio and Wolf Point's delinquent payments increased from 27 percent to 53 percent. The largest decreases in delinquent loans occurred in Butte (23 percent to 6 percent) and Colstrip (24 percent to 6 percent). Much of Colstrip's decrease may be due to the MBDC leaving the program and no longer making microloans. The Great Falls MBDC had a 45 percent drop in delinquent payments. However, much of this drop was likely due to the MBDC writing off almost \$91,000 in loans since November 2000. The Great Falls MBDC is no longer participating in the program.

MBDCs Are Not Financially Self-Sustaining

During the audit, we noted the statewide net loss (expenses exceeding revenues) for the MBDCs was \$342,921. Only one MBDC showed a positive change in net assets. We reviewed financial information reported to the department by each MBDC with an outstanding development loan balance. Information reviewed was for the quarter ended June 30, 2003. Our review found the MBDCs continue to have financial difficulties. The following table provides information related to revenues and expenditures for MBDCs that are still participating in the program reported to the department.

Table 2
MBDC Revenues and Expenditures
June 30, 2003

	<u>Kalispell</u>	<u>Missoula</u>	<u>Butte</u>	<u>Helena</u>
<u>INCOME</u>				
Interest Rec'd from microloans	\$ 7,105	\$ 5,466	\$ 2,896	\$ 6,228
Fees Rec'd from microloans	\$ 3,530	\$ 395	\$ 123	\$ 100
Interest on deposits & investments	\$ 509	\$ 1,511	\$ 1,122	\$ 339
Other	\$ 7,500	\$ 0	\$ 7,500	\$ 232
Total Revenues	\$ 18,644	\$ 7,372	\$ 11,641	\$ 6,899
<u>EXPENSES</u>				
Interest pd for MDOC loans	\$ 3,432	\$ 4,613	\$ 2,250	\$ 2,419
Interest pd for other debt	\$ 0	\$ 244	\$ 0	\$ 0
Bad Debt Expense	\$ 5,571	\$ 0	\$ 0	\$ (100)
Operating Expenses	\$ 16,566	\$ 21,750	\$ 3,808	\$ 6,613
Total Expenses	\$ 25,569	\$ 26,607	\$ 6,058	\$ 8,932
Change in Net Assets *	\$ (6,925)	\$ (19,235)	\$ 5,583	\$ (2,033)

	<u>Havre</u>	<u>Billings</u>	<u>Wolf Point</u>	<u>Total</u>
<u>INCOME</u>				
Interest Rec'd from microloans	\$ 9,922	\$ 9,348	\$ 8,843	\$ 49,808
Fees Rec'd from microloans	\$ 792	\$ 2,903	\$ 100	\$ 7,943
Interest on deposits & investments	\$ 226	\$ 2,172	\$ 0	\$ 5,879
Other	\$ 5,344	\$ 10,633	\$ 0	\$ 31,209
Total Revenues	\$ 16,284	\$ 25,056	\$ 8,943	\$ 94,839
<u>EXPENSES</u>				
Interest pd for MDOC loans	\$ 7,912	\$ 3,424	\$ 0	\$ 24,050
Interest pd for other debt	\$ 0	\$ 0	\$ 0	\$ 244
Bad Debt Expense	\$ 0	\$ 4,453	\$ 0	\$ 9,924
Operating Expenses	\$ 13,331	\$ 10,733	\$ 4,890	\$ 77,691
Total Expenses	\$ 21,243	\$ 18,610	\$ 4,890	\$ 111,909
Change in Net Assets *	\$ (4,959)	\$ 6,446	\$ 4,053	\$ (17,070)

* Similar to net profit (loss)

Source: Compiled by the Legislative Audit Division from department records.

The table shows four of seven MBDCs have a net loss for the quarter ended June 30, 2003. As a whole, the MBDCs had a total net loss of over \$17,000 dollars. However, our follow-up found MBDCs did not report all their expenses to the department. Specifically, we noted MBDCs were not accurately reporting their bad debt expenses. Bad debt expenses represent the on-going cost of probable loan losses. Department of Commerce policies require MBDCs to estimate the allowance for loan losses on a regular basis based upon their outstanding loan portfolio. We noted several MBDCs underestimated or did not report any bad debt expenses for the quarter. For example, the Wolf Point MBDC reported no bad debt expenses even though they had more than \$196,000 in delinquent loans.

To obtain a more accurate picture of the MBDC's financial condition, we adjusted their expenses by using information related to delinquent loans for each MBDC (see table one). We estimated one-quarter of each MBDC's delinquent loans as the on-going cost of probable loan losses. After readjusting bad debt expenses based on MBDC delinquent loan information, the financial condition of the MBDCs further deteriorates. Based on our readjustment, six of seven MBDCs are operating a net loss for the quarter ending June 30, 2003 and the MBDCs statewide net loss increased from \$17,070 to \$131,078. This represents 58 percent of the programs total expenses. Table three shows total net assets for each MBDC after making this adjustment.

Table 3
MBDC Revenues and Expenditures After Readjusting Bad Debt Expenses
June 30, 2003

	<u>Kalispell</u>	<u>Missoula</u>	<u>Butte</u>	<u>Helena</u>
<u>INCOME</u>				
Interest Rec'd from microloans	\$ 7,105	\$ 5,466	\$ 2,896	\$ 6,228
Fees Rec'd from microloans	\$ 3,530	\$ 395	\$ 123	\$ 100
Interest on deposits & investments	\$ 509	\$ 1,511	\$ 1,122	\$ 339
Other	\$ 7,500	\$ 0	\$ 7,500	\$ 232
Total Revenues	\$ 18,644	\$ 7,372	\$ 11,641	\$ 6,899
<u>EXPENSES</u>				
Interest pd for MDOC loans	\$ 3,432	\$ 4,613	\$ 2,250	\$ 2,419
Interest pd for other debt	\$ 0	\$ 244	\$ 0	\$ 0
Bad Debt Expense	\$ 35,093	\$ 0	\$ 2,682	\$ 0
Operating Expenses	\$ 16,566	\$ 21,750	\$ 3,808	\$ 6,613
Total Expenses	\$ 55,091	\$ 26,607	\$ 8,740	\$ 9,032
Change in Net Assets *	\$ (36,447)	\$ (19,235)	\$ 2,901	\$ (2,133)

	<u>Havre</u>	<u>Billings</u>	<u>Wolf Point</u>	<u>Total</u>
<u>INCOME</u>				
Interest Rec'd from microloans	\$ 9,922	\$ 9,348	\$ 8,843	\$ 49,808
Fees Rec'd from microloans	\$ 792	\$ 2,903	\$ 100	\$ 7,943
Interest on deposits & investments	\$ 226	\$ 2,172	\$ 0	\$ 5,879
Other	\$ 5,344	\$ 10,633	\$ 0	\$ 31,209
Total Revenues	\$ 16,284	\$ 25,056	\$ 8,943	\$ 94,839
<u>EXPENSES</u>				
Interest pd for MDOC loans	\$ 7,912	\$ 3,424	\$ 0	\$ 24,050
Interest pd for other debt	\$ 0	\$ 0	\$ 0	\$ 244
Bad Debt Expense	\$ 25,936	\$ 11,035	\$ 49,186	\$ 123,932
Operating Expenses	\$ 13,331	\$ 10,733	\$ 4,890	\$ 77,691
Total Expenses	\$ 47,179	\$ 25,192	\$ 54,076	\$ (225,917)
Change in Net Assets *	\$ (30,895)	\$ (136)	\$ (45,133)	\$ (131,078)

* Similar to net profit (loss)

Note: Bad debt expenses would generally be written off over time and not all be expensed against one quarter's income. Therefore, the change in net assets may be larger than normal.

Source: Estimated by the Legislative Audit Division based on department information.

It should be noted the umbrella organization covers losses experienced by MBDCs, not the State of Montana. For example, if an MBDC is located within a local economic development corporation, this organization subsidizes the program's loan losses. However, these funds are then no longer available to the organization for other programs. Some MBDCs have ceased operations in the past because the entities where they were located no longer wanted to risk their assets to subsidize the program. Since our follow-up found several MBDCs continue not to be financially self-sustaining this potential continues to exist. We have no reason to believe this situation will change in the near future.

Outstanding Development Loan Balance Is Decreasing

The Department of Commerce makes development loans to MBDCs for the purpose of making microbusiness development loans. Interest from the development loans pay the department's administrative costs to oversee the program. The outstanding balance for development loans made to MBDCs has decreased since the completion of our audit. This reduces the department's exposure to potential financial losses should MBDCs or their umbrella organization default on repaying their development loan. It is important to note that an organization has never defaulted on a development loan. All MBDCs that have left the program have either paid their development loan in full or are in the process of paying it off. However, until the loans are paid off the exposure for loss is always there. The following table compares the development loan balances from June 30, 2000 to the balance for June 30, 2003.

**Table 4
Development Loan Balance Comparison
(June 30, 2000 and June 30, 2003)**

<u>MBDC</u>	<u>Loan Balance June 30, 2000</u>	<u>Loan Balance June 30, 2003</u>	<u>Difference</u>
Billings	\$ 498,000	\$ 198,000	\$(300,000)
Bozeman	113,686	0	(113,686)
Butte	327,226	327,226	0
Colstrip	250,000	92,686	(157,314)
Glendive	9,175	0	(9,175)
Great Falls	419,452	161,967	(257,485)
Havre	1,150,852	1,150,852	0
Helena	378,713	378,713	0
Kalispell	499,148	475,641	(23,507)
Lewistown	0	0	0
Missoula	790,000	790,000	0
Wolf Point	630,000	630,000	0
Total	\$5,066,252	4,205,085	\$(861,167)

Note: This chart shows every MBDC that has participated in the Microbusiness Finance Program.

Source: Compiled by the Legislative Audit Division from department records.

As the table shows, the development loan balance has decreased by more than \$861,000 over the last two years. The majority of this decrease has come from MBDCs who have left the program and either paid off their development loan or are in the process of paying it off.

SUMMARY

Our follow-up found the department has implemented or is in the process of implementing all recommendations made in the performance audit of the Microbusiness Finance Program. They have also established procedures to review MBDC lending activities through an on-site review process. However, despite the department's efforts, the program's loan portfolio continues to have high delinquency rates and the potential for significant loan losses. Our follow-up review also found the MBDCs are still not financially self-sufficient as intended when the legislature created the program. Based on our review, it does not appear it may be possible for most MBDCs to ever be financially self-sufficient. The legislature may once again need to evaluate the future of the Microbusiness Finance Program. We believe the legislature could consider three options for the program:

- ▶ The program could continue to operate and be given more time to see if the department's changes eventually improve how effectively the program operates.
- ▶ The program could be eliminated and all MBDCs and/or their umbrella agencies be required to pay back all development loans and continue to collect outstanding microloans until fully collected.
- ▶ The Microbusiness Development Act could be amended eliminating the need to use local MBDCs to make microloans. Instead, the program could make funding available to local banks to make microloans to borrowers. This could potentially improve the quality of loans that are made.